No. 20621

In the

United States Court of Appeals

For the Ninth Circuit

JOHN M. ROGERS and JOHN M. ROGERS, Executor of the Estate of Gladys B. Rogers, deceased,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitioners' Reply Brief

EDWARD J. RUFF
MICHAEL L. MELLOR
GRAHAM G. CAMPBELL
JAMES R. BRIDGES
THELEN, MARRIN, JOHNSON & BRIDGES
111 Sutter Street
San Francisco, California 94104

Attorneys for Petitioners

SORG PRINTING COMPANY OF CALIFORNIA, 346 FIRST STREET, SAN FRANCISCO 94105

SUBJECT INDEX

TABLE OF AUTHORITIES CITED

Cases

Other Authorities

No. 20621

In the

United States Court of Appeals

for the Ninth Circuit

JOHN M. ROGERS and JOHN M. ROGERS, Executor of the Estate of Gladys B. Rogers, deceased,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitioners' Reply Brief

I.

INTRODUCTORY STATEMENT

The most significant aspect of respondent's 37 page brief is that respondent's analysis of the case of *Alderson v. Commissioner,* 317 F.2d 790 (9th Cir. 1963) begins and ends on page 36. Respondent's attempt at distinguishing *Alderson* is futile, for respondent concedes, as it must, that this Court held in *Alderson* that Section 1031(a) was satisfied even though Alloy, one of the two parties to the exchange,

never acquired any real interest in the property exchanged by it, even though taxpayer had previously entered into a contract to purchase that property from a third party (the Salinas owner), and even though the transaction was arranged in the form of an exchange by the taxpayer for the purpose of tax avoidance. Respondent's sole ground for distinguishing *Alderson* is that Alloy "actually acquired title to the exchange property," even though such title was immediately reconveyed to taxpayer. As we pointed out in our opening brief, by virtue of petitioners' and the Sharons' escrow instructions, which must be presumed to have been carried out in full accordance with their terms, the Sharons likewise acquired title to 571 Market Street, although, like Alloy in *Alderson,* such title was immediately reconveyed. The fact that the Sharons' acquisition of title and the reconveyance thereof was ultimately handled by the escrow holder, for its own internal reasons, in the form of a single recording transaction, obviously is without significance.

Respondent contends that Standard Oil's contractual rights with respect to 571 Market Street somehow prevented the Sharons from acquiring title thereto. The simple and conclusive answer to this premise is that even if Standard Oil had at some time acquired a contractual right to the property, that would not prevent the passage of title to the Sharons, as the cases cited in petitioners' opening brief point out. Thus, the instant case fits squarely within the *Alderson* rule.

Keeping in mind the fact that the *Alderson* case must ultimately control the disposition of this matter, we will in the pages which follow meet the various other points which respondent has raised. None of these points in any way brings this case outside the scope of the *Alderson* decision.

II.

PETITIONERS DIRECTLY EXCHANGED 571 MARKET STREET FOR THE SHARON BUILDING

In part C of its brief, respondent attempts to meet petitioners' primary contention that a direct exchange was in fact consummated between petitioners and the Sharons.

Respondent's first point is that petitioners "committed themselves" to selling 571 Market Street to Standard Oil by granting it an option to purchase that property, and that such option "unqualifiedly" gave Standard Oil the right to purchase that property. As we have already pointed out (P.B. 15, 20-21), neither the granting of the option nor the subsequent exercise thereof in any way prevented petitioners from conveying title to 571 Market Street to the Sharons, who took title to that property subject to whatever contractual rights Standard Oil might have. Respondent does not discuss the cases and authorities set forth in petitioners' opening brief, nor does it dispute the validity of their holding. The conveyance of 571 Market Street by petitioners to the Sharons was neither invalid nor a breach of contract as respondent suggests. The law is clear that there is an unqualified right to convey property subject to an outstanding option or other contractual right. Such a conveyance was made here, and Standard Oil's rights were fully protected by the conveyance to the Sharons.

Respondent argues that Standard Oil did not have to agree, and did not agree to the exchange. (R.B. 29). We pointed out that in fact the evidence shows that Standard Oil and its agent, Cal Pac, fully acquiesced in the exchange. (P.B. 21). But aside from that, such acquiescence was unnecessary, since petitioners had the legal right to convey title to their property to the Sharons.

Respondent argues that petitioners' title to 571 Market Street "was subject to immediate divestment upon the per-

formance of the conditions of the sales contract between the taxpayers and Standard Oil." (R.B. 30). But the very cases relied upon by respondent to support this position refute this contention. For example, *Todd v. Vestermark,* 145 Cal. App. 2d 374, 377, 302 P.2d 347, 349 (1956), points out that the title to property passes only when all conditions contained in the parties' escrow instructions have been carried out. Petitioners' escrow instructions authorized Cal Pac to deliver a deed to 571 Market Street only *to the order of the Sharons,* upon vesting title to the Sharon Building in petitioners. The Sharons' escrow instructions authorized Cal Pac to reconvey 571 Market Street *on behalf of the Sharons* to Standard Oil. The *Todd* case, and the other cases cited by petitioners (P.B. 22) hold that such escrow instructions must be carried out in full accordance with their terms and that a deed delivered contrary thereto is void. Therefore, while Standard Oil, at some time subsequent to the exercise of its option, may have established a contractual right to 571 Market Street upon complying with the various terms and conditions of the option agreement, title to the property remained in petitioners at all times prior to January 16, 1958, at which time it passed to the Sharons, in accordance with petitioners' escrow instructions.

Respondent correctly points out that on January 31, 1958, Cal Pac conveyed title to 571 Market Street "*directly* from itself to Standard Oil." But respondent's conclusion that petitioners "must be deemed to have ratified that conveyance" (R.B. 32-33) is pure nonsense. Cal Pac, in a letter dated January 29, 1958, confirmed the fact that the exchange had been effected prior to that time, stating that petitioners had acquired the Sharon Building "in consideration of the sum of $400,000.00 and the exchange of Market Street property, which was sold in the same transaction, for a

consideration of $750,000.00" (C.T. 154; Exh. 35-H, C.T. 138).

Respondent's final argument is that the Sharons "never intended" and "were unwilling" to acquire 571 Market Street subject to an unexercised option. Respondent bases its contention upon the fact that the Sharons' escrow instructions, dated January 16, 1958, "make no mention of any such exchange subject to an unexercised option." (R.B. 31). What respondent fails to point out is that Standard Oil had exercised its option nearly a month before these instructions were delivered. (C.T. 150-151; Exh. 14 N, C.T. 89). To contend that any inference can be drawn from the fact that the Sharons simply recognized an accomplished fact, rather than ignoring that fact, is the purest sophistry. The Sharons, realizing that Standard Oil had exercised its option, simply combined a two-step transaction into one set of escrow instructions to provide for the conveyance of the Sharon Building to petitioners in exchange for 571 Market Street and $400,000 cash from petitioners, and the subsequent sale of 571 Market Street *on behalf of the Sharons* to Standard Oil.

At any rate, the evidence is uncontradicted that petitioners and the Sharons *negotiated* on the basis of an exchange of the Sharon Building for 571 Market Street, subject to the unexercised option (C.T. 147-148; R.T. 25-27), that the Sharons actually made an *offer* to value the Sharon Building at $1,150,000 for purposes of such an exchange (C.T. 148; R.T. 25-27), that the Sharons, through their agents Coldwell-Banker & Co., prepared an *agreement* setting forth the details of such an exchange, which petitioners executed (C.T. 148-149; R.T. 29; Exh. 39, C.T. 142), that in accordance with the terms of such agreement the Sharons *opened an escrow* for purposes of consummating the ex-

change (C.T. 149; R.T. 29), and that petitioners placed into that escrow their *deed* to 571 Market Street accompanied by escrow instructions authorizing delivery of that deed *to the order of the Sharons* upon vesting title to the Sharon Building in petitioners (C.T. 150; Exh. 12-L, 13-M, C.T. 86, 87). *All these events occurred before Standard Oil had exercised its option.* Clearly, these facts preclude any inference that the Sharons and petitioners were bargaining on the basis of a sale of the Sharon Building, as respondent contends.

The uncontroverted facts compel the conclusion that the Sharons' escrow instructions, together with petitioners' instructions, were carried out by Cal Pac, and that an exchange of properties was accomplished prior to Standard Oil's acquisition of 571 Market Street from the Sharons. Having acquired title from petitioners, it is insignificant that the Sharons acquired no real interest in the property, as we pointed out in our discussion of this Court's decision in *Alderson v. Commissioner,* 317 F.2d 790 (9th Cir. 1963), at pages 24-25 of our opening brief. Indeed, respondent apparently concedes that if the Sharons acquired title to 571 Market Street, the transaction would qualify under the *Alderson* rule. (R.B. 36).

III.

SECTION 1031(a) APPLIES TO CERTAIN SIMULTANEOUS SALES AND PURCHASES IN ESCROW

In petitioners' opening brief, pages 28 through 32, we set forth an alternative argument based upon the theoretical assumption that the Tax Court correctly held that the instant transaction took the form of a simultaneous sale and purchase. In part B of its brief, respondent attempts to meet petitioners' alternative theory, employing the familiar "parade of horrors" argument and stating that if peti-

tioners' interpretation of Section 1031(a) is accepted, it will open wide the floodgates and create a "serious erosion of the capital gains tax base," and a "pyramiding" of tax-free capital.

There are two sufficient answers to respondent's contention. First, petitioners have never suggested that Section 1031(a) should apply to all situations involving sales and subsequent purchases, or even to all situations involving simultaneous sales and purchases. Petitioners do strongly urge that in real estate transactions involving common escrow agents and simultaneous transfers of property, the intent of the parties and the net effect of the transactions should control over the bare form these transactions take. (P.B. 31-32).

Second, it should be quite clear that such an interpretation will not lead to any further "erosion" of the tax base, for the courts unquestionably sanction the use of conduit transactions whereby tax-free exchanges are effected by arranging for the other exchanging party to acquire paper title to the property desired by the taxpayer.

Let us explore each of these points in greater detail. We will assume, solely for purposes of argument, that the Tax Court correctly held that the form of the instant transaction was a "sale" of 571 Market Street by petitioners to Standard Oil, and a simultaneous "purchase" of the Sharon Building by petitioners from the Sharons out of the proceeds of that sale.

It is clear that this situation meets all the tests of the cases upon which respondent so heavily relies, *Jordan Marsh Company v. Commissioner*, 269 F.2d 453, 456 (2d Cir. 1959), and *Trenton Cotton Oil Co. v. Commissioner*, 147 F.2d 33 (6th Cir. 1945), cited by respondent at pages 22-25 of its brief. Petitioners' gain remained a paper gain,

still tied-up in like property, and not realized in a popular or economic sense, but merely theoretical in nature. Moreover, this situation likewise meets all the tests of the recent case of *Coastal Terminals, Inc. v. United States,* 320 F.2d 333, 337 (4th Cir. 1963), discussed by petitioners at pages 30-32 of their opening brief. Petitioners *intended* to effect an ultimate exchange, and the *net effect* of the transaction was an exchange.

This situation is entirely different from the ordinary sale and reinvestment situation postulated by respondent, where the reinvestment or subsequent purchase is totally unrelated and unrestricted by the original sale, and where the decision to reinvest is made *after* the proceeds or right to proceeds from that sale have accrued. In those situations, the gain is no longer "tied-up," taxpayer has "cashed in" on his investment, and the fact that he voluntarily chooses to reinvest the proceeds in like property should not alter the tax consequences arising therefrom. In the words of Mr. Green of Iowa, quoted at page 23 of respondent's brief "If the property has been *reduced to cash* and there is a gain, of course it will be taxed." (Emphasis added).

However, where the taxpayer, with the intent to effect an ultimate exchange through a simultaneous transfer of properties, and before any right to sales proceeds has accrued, provides for the distribution of these proceeds directly from the purchaser of his property to the seller of the property he desires, the transaction should be treated as an exchange under Section 1031(a). The logic of this proposition becomes even more compelling when applied to escrow transactions involving common escrow holders, where the form the transactions take is largely dictated by the judgment of the escrow holder and other factors over which the parties have little or no control.

Respondent's additional arguments with respect to the scope of Section 1031(a) are without merit. Respondent, at page 25, footnote 8, suggests, without citation of authority, that an exchange cannot qualify under Section 1031(a) unless the other party to the exchange retains the property transferred to him by the taxpayer. Obviously, whether the *taxpayer* has qualified under Section 1031(a) cannot depend upon whether the other party to the exchange has or has not retained an interest in the property received from taxpayer.

Respondent asserts at page 25 that petitioners or Cal Pac received proceeds or the right to proceeds from Standard Oil over which they had dominion and control. First of all, petitioners never received any of the proceeds deposited in escrow by Standard Oil. Second, petitioners effectively placed any right to receive such proceeds beyond their reach by executing the Agreement to Exchange and performing in accordance with its terms by depositing a deed and escrow instructions into the exchange escrow before Standard Oil had exercised its option. Finally, as for Cal Pac, whatever payment it received from Standard Oil remained the property of Standard Oil all times prior to its transfer to the Sharons. (P.B. 17).

Respondent's final argument is its "erosion" point, to the effect that since sales and contemporaneous purchases of similar property are "easily arranged," the Court should adopt respondent's view of Section 1031(a) to prevent a "serious erosion of the capital gains tax base."

Let us examine this contention in detail. Assume that Mr. T, the owner of T property, desires to effect a tax-free exchange of that property for A property, owned by Mr. A. Asume further that A desires to sell A property for cash, rather than to acquire T property, and that Mr. B is willing

to purchase T property for cash. Respondent contends that if T is permitted to qualify under Section 1031(a) by arranging for a simultaneous sale and purchase of these properties in escrow, with the proceeds of the sale by A payable directly from B to A, the tax base will be seriously eroded. Respondent overlooks the fact that the law already permits T to qualify under Section 1031(a) simply by arranging for B to take title to A property and immediately to reconvey the same to T in exchange for T property. *Alderson v. Commissioner,* 317 F.2d 790 (9th Cir. 1963); *Coastal Terminals, Inc. v. United States,* 320 F.2d 333 (4th Cir. 1963); *Mercantile Trust Co.,* 32 B.T.A. 82 (1935), *acq.* XIV-1 Cum. Bull. 13; *Antone Borchard,* 24 T.C. Memo. 1643 (1965).

Countless cases, including this Court in the *Alderson* case, have held that for tax purposes substance must control over form. We maintain that simultaneous sales and purchases in escrow intended to accomplish an ultimate exchange, and having the net effect of such an exchange, should be treated no differently than exchanges effected through conduit transactions arranged in the form of an exchange for tax purposes.

Therefore, even if this Court were to agree with the Tax Court that petitioners and the Sharons did not effect a direct exchange of their property, we maintain that under the particular facts of this case, the transaction should be treated as an exchange under Section 1031(a).

IV.

PETITIONERS DID EFFECT A LIKE KIND EXCHANGE UNDER SECTION 1031(a)

In part D of its brief, respondent raises an argument not made before the Tax Court and attempts to demon-

strate that, even though "(1) the directions in the escrow instructions to convey title to 571 Market Street to the order of the Sharons and on their order to Standard Oil . . . are to be taken at face value and (2) the taxpayers still held a vendor's title on January 16, 1958," an exchange qualifying under Section 1031(a) was not effected because there was no exchange of properties of a "like kind."

Respondent then proceeds to base its argument with respect to the "like kind" requirement on a total disregard of the escrow instructions of petitioners and the Sharons, and a denial, grounded on such disregard, that petitioners held title to 571 Market Street on January 16, 1958. Respondent briefly recites some general law with respect to escrows and escrow holders and passes immediately to the conclusion that title to 571 Market Street passed to Standard Oil "in any event, . . . before January 16, 1958," and that, therefore, no exchange of like kind property could have occurred on January 16, 1958.

The only basis offered for this conclusion appears in footnote 15 on page 35 of respondent's brief. Therein respondent states that "the taxpayers had delivered a deed to the title company conveying 571 Market Street to that company on December 17, 1957. . . . Standard Oil delivered the balance of the entire purchase price money by check . . . to the title company in escrow on December 20, 1957." Though purporting to take petitioners' (and the Sharons') escrow instructions at face value, respondent fails to mention in said footnote 15 that petitioners' escrow instructions to Cal Pac, which accompanied transmittal of its deed to Cal Pac, specifically instructed Cal Pac "to deliver said deed to the order of Hurford C. Sharon, et al.," when Cal Pac had vested title to the Sharon Building in petitioners, and in no way authorized a delivery of that deed to Standard

Oil, or to Cal Pac acting on behalf of Standard Oil. Cal Pac's only authorization to deliver the deed to 571 Market Street to Standard Oil or to its order came from the Sharons, and was specifically conditioned upon receipt by Cal Pac, on behalf of the Sharons, of a conveyance of 571 Market Street from the petitioners, and receipt by Cal Pac, for the account of the Sharons, of the option price from Standard Oil.

Thus, delivery of a deed to 571 Market Street from Cal Pac to Standard Oil or its order, whenever such delivery occurred, was made possible only because, prior to such delivery, an exchange of 571 Market Street and the Sharon Building between petitioners and the Sharons had been consummated pursuant to the escrow instructions of the petitioners and the Sharons. Cal Pac could not have made such a delivery prior to the consummation of the exchange. This is amply demonstrated by *Todd v. Vestermark,* 145 Cal.App.2d 374, 377, 302 P.2d 347, 349 (1956), the case relied upon by respondent on this point:

> "It is established in this state that the terms and conditions of an escrow must be strictly performed. [Citing, among others, *Los Angeles High School Dist. v. Quinn,* 195 Cal. 377, 234 Pac. 313 (1925), the case cited by petitioners on this same point at page 22 of their opening brief.] The doctrine of substantial performance does not apply. [Citations.] The escrow holder is agent for both parties at all times prior to performance of the conditions of the escrow, but when that event transpires '. . . the nature of this dual agency changes to an agency not for both, but for each of the parties to said transaction in respect to those things placed in escrow to which each has thus become completely entitled.' [Citations.] When the conditions have been fully performed, title passes *eo instanti* and recordation of documents operates to evidence the passing of title

previously accomplished. [Citations.] *On the other hand, a delivery or recordation by or on behalf of the escrow holder prior to full performance of the terms of the escrow is a nullity.* [Citations.]" [Emphasis added.]

Thus, if the escrow instructions of the petitioners and the Sharons are "taken at face value" (and *Todd* shows that they cannot be taken otherwise), it is unquestionable that the exchange of 571 Market Street for the Sharon Building was consummated before the deed to 571 Market Street was delivered to Standard Oil by Cal Pac acting on behalf of the Sharons.* Respondent's arguments fail to prove that a "like kind" exchange did not occur and in fact, when the content of the escrow instructions are kept in mind, conclusively prove that such an exchange did occur.

Respondent also states that petitioners had a right to assign "their contractual right to receive the sales proceeds for their property from Standard Oil." Of course petitioners could have structured the transaction so as to make such an assignment. It is clear that petitioners could have chosen not to negotiate and consummate an exchange with the Sharons, and instead could have retained 571 Market Street and consummated a contract of sale and purchase with Standard Oil, assigning the right to the proceeds from such a sale to the Sharons or someone else. These things might have been done. They were not done. Instead, as has been demonstrated above, petitioners never consummated any such contract and never assigned any right to sales proceeds to anyone: *Before* Standard Oil exercised

---

*That title to 571 Market Street remained in petitioners, up to January 16, 1958, is further evidenced by the fact that petitioners, with full knowledge of all parties, received and retained rentals on that property accruing on or before that date. (C.T. 154.) Respondent's argument conveniently ignores this admitted fact.

its option, petitioners executed an exchange agreement and, pursuant thereto, deposited in escrow a deed to 571 Market Street together with escrow instructions requiring delivery of that deed to the Sharons. *Before* the Sharons effected a sale of 571 Market Street to Standard Oil, the exchange of 571 Market Street for the Sharon Building was fully consummated, in accordance with the escrow instructions of petitioners and the Sharons. Respondent does not deny that petitioners had every right to effect such an exchange:

> "As long as legal title remains in the vendor it may be conveyed by him, and a vendor under an executory contract for the sale of land may sell to a third person the land covered by the contract, at the same time assigning the contract, or he may merely convey the land subject to the prior rights of the purchaser under the contract." 50 Cal.Jur.2d, *Vendor and Purchaser,* sec. 133, at p. 172 (1959).

This being the case, *Commissioner v. P. G. Lake, Inc.,* 356 U.S. 260 (1958), rehearing denied, 356 U.S. 964, is inapplicable to this case.*

---

*Petitioners also would point out that the decision in *Lake* did not turn upon the question whether "a contractual right to cash can qualify as like kind property under Section 1031(a)." In *Lake,* five cases involving partial assignments of oil payment rights were consolidated for trial since in each the contention was that gains realized on such assignments were taxable at capital gain rates. One of those cases also raised the question whether such an assignment in return for real property qualified under the predecessor to section 1031(a) and entitled the taxpayer to postpone the capital gain. The Court viewed the arguments of the taxpayers as attempts to convert ordinary income into capital gains, holding that, in view of the limited nature of the assignments, the rights which were being assigned were rights to *ordinary* income. Thus these partial assignments did not constitute "conversions of capital investments" and any gain realized was ordinary income. It followed that an exchange of real estate for such a non-capital asset did not qualify under the predecessor to section 1031(a). Here respondent is not contending that petitioners are converting ordinary income into capital gain. On the contrary, respondent's position is that petitioners realized and must recognize capital gain.

The purpose of the "like kind" requirement is to allow an exchange to qualify as tax free under section 1031(a) only when the taxpayer's investment remains essentially unchanged after the exchange. As the Court in *Lake* pointed out:

> "[T]he 'underlying assumption . . . is that the new property is substantially a continuation of the old investment still unliquidated.' " [356 U.S. at p. 268, quoting from the regulations to the predecessor section of section 1031(a).]

See also *Jordan Marsh Company v. Commissioner,* 269 F.2d 453, 455 (2d Cir. 1959), quoted at pages 28-29 of petitioners' opening brief.

There can be no question that 571 Market Street and the Sharon Building were both office buildings held as rental income investment property by their respective owners prior to January 16, 1958,* were, therefore, "like kind" properties, were exchanged for each other on January 16, 1958, and that petitioners thereafter held the Sharon Building for the same purposes they had previously held 571 Market Street. Thus, the interjection of the "like kind" argument, an argument not raised in the Tax Court and apparently raised here as an afterthought, does not avail respondent, and merely serves to confuse the sole issue before the Court—does the transaction between petitioners and the Sharons qualify as a tax-free exchange under section 1031(a). Petitioners urge that this question must be answered in the affirmative.

---

*That petitioners so held 571 Market Street until January 16, 1958 is demonstrated by the fact that petitioners received and retained all rentals accruing on the property up to that date. (C.T. 154.)

Petitioners respectfully submit that the decision of the Tax Court herein was incorrect and should be reversed.

Dated: May 24, 1966.

Edward J. Ruff
Michael L. Mellor
Graham G. Campbell
James R. Bridges
Thelen, Marrin, Johnson & Bridges

By Michael L. Mellor
Attorneys for Petitioners

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Michael L. Mellor